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December 13, 2013

Councilman Morrison,

As you know, we will be having a very important discussion in Executive Session next Tuesday on the subject of employee pensions. The administration is not presenting an ordinance or asking for any votes. Rather, our aim is to present an objective overview of the situation as well as our recommendations for moving forward.

Because of the gravity of this issue, we are getting this comprehensive package of information to you in advance of the Tuesday meeting so that you have time to review it, formulate any questions you may have or request additional information.

The goal is to engage the Council and give you an opportunity to ask questions and provide guidance.

To that end, I have attached the PowerPoint presentation that Director Collins will walk us through next Tuesday. In the binder behind the presentation, you will find numerous documents and reports that provide valuable background information on this subject. They include everything from the original PwC report from September 14, 2013 that outlined the situation and our alternatives, to the various actuarial analysis provided by the unions.

There is no doubt that we face a serious financial challenge. The primary source of the problem is an outdated defined benefit pension plan that, despite the best intentions, we can no longer afford. We recommend closing the old defined benefit plan and replacing it with a safer, more secure defined contribution plan. Retirees and vested employees with ten years on the job (3,707 or 60%) will stay with the old plan and finish out their careers and retirements. Unvested (2,428 or 40%) and new employees will participate in the new defined contribution plan.

Also, we must find a way to pay the unfunded liability that has accumulated under the old defined benefit plan. This will require a concerted effort by the administration and Council to reallocate our resources in a way that both addresses this commitment and allows us to deliver the level of city services our citizens deserve and expect.

This is the challenge before us. I look forward to meeting with you next Tuesday to begin the discussion on how we will find a solution together, as One Memphis.

Regards,

A handwritten signature in black ink, appearing to read "A C Wharton, Jr."

A C Wharton, Mayor, City of Memphis

# Pension Benefits Reform



Presentation to Memphis City Council  
Executive Session

December 17, 2013

Brian Collins  
Director of Finance

Quintin Robinson  
Director of Human Resources

# Growing Unfunded Pension Liability

(In '000)

Plan Year	Actuarial Assets	Actuarial Liability	Unfunded Liability	Funded Ratio
1-Jul-08	\$2,184,255	\$2,090,088	\$94,167	104.5%
1-Jul-09	\$1,773,457	\$2,222,984	(\$449,527)	79.8%
1-Jul-10	\$1,805,071	\$2,336,075	(\$531,004)	77.3%
1-Jul-11	\$1,838,424	\$2,447,974	(\$609,550)	75.1%
1-Jul-12	\$1,867,934	\$2,509,930	(\$641,996)	74.4%
1-Jul-13	\$1,883,786	\$2,592,987	(\$709,201)	72.6%

# ARC v. Contribution

## A History of Underfunding

Annual				City		
Plan	Required	ARC as	City's	Contribution	Underfunded	
Year	Contribution	% of Payroll	Contribution	Rate	Amount	
1-Jul-08	\$21,208,000	7.5%	\$16,172,000	5.0%	(\$5,036,000)	
1-Jul-09	\$71,447,000	24.1%	\$17,419,000	5.0%	(\$54,028,000)	
1-Jul-10	\$80,021,000	25.9%	\$20,132,000	6.0%	(\$59,889,000)	
1-Jul-11	\$89,006,000	28.1%	\$21,108,000	6.0%	(\$67,898,000)	
1-Jul-12	\$90,363,000	30.3%	\$18,968,000	6.0%	(\$71,395,000)	
1-Jul-13	\$96,024,000	31.5%	\$19,530,000	6.0%	(\$76,494,000)	

# Defined Benefit “Risks”

- The City of Memphis Defined Benefit Plan contains certain inherent “risks” that inevitably – as happened in 2008-09 – increase costs and can have extremely disruptive impacts on budgets and, ultimately, the level of city services we can deliver:
- **Interest Rate Risk**
  - Unpredictable and can cause volatility in investment returns as value of bond holdings can fluctuate, sometimes substantially, with interest rates
- **Market Risk**
  - Extremely volatile equity and bond markets can cause short and long-term losses that city must cover, such as the \$500 million loss suffered in 2009!
- **Mortality Risk**
  - As we live longer, the city must carry additional risk of making larger payments, and *making them longer*
- **Inflation Risk**
  - Inflation, especially when it hits the double digits, can substantially increase benefit costs that are tied to compensation levels

# Conclusions and Warnings

- **Actuary's (PwC) Conclusion:**

- "Based upon the actuarial assumptions used to determine the plan's liability and ARC, a projection of a workforce similar in size to the current one, and the current funding policy of 6.0% of compensation, the plan is not sustainable in the long-term.

- **Comptroller of State of Tennessee:**

- "The City appears to have funding needs in the near future for liabilities related to pension obligations, other post-employment benefit obligations...the City must submit its budget for approval by the Comptroller who is to determine whether or not the budget will be in balance in accordance with the Act. If the budget does not comply with the Act, then the Comptroller has the power and the authority to direct Council...to make additional tax levies sufficient to comply with the Act." (May 20, 2013 letter to City of Memphis from Comptroller Wilson)
- "...very substantial challenges remain. For example, we understand the City is in the process of... reforming its pension plan to address the significant unfunded obligations. I would impress upon the City that it is *imperative that it pursue those efforts with dispatch.*" (October 7, 2013 letter to Mayor Wharton from Comptroller Wilson)

# Key Elements of Analysis

## Potential Disagreement?

	<b>City of Memphis</b>	<b>Firefighters' Position</b>	<b>Impact on Unfunded Liability</b>
<b>Discount Rate*</b>	7.5%	7.9%	Lower Liability
<b>Pension Asset</b>	Actuarial Value	Market Value	Lower Liability
<b>Salary Growth</b>	5.0%	3.5%	Lower Liability
<b>Amortization Method</b>	Level Dollar	% Payroll	Lower Liability
<b>Unfunded Liability**</b>	\$682 million	\$301 million	Lower Liability
<b>Annual Cost</b>	\$90 million	\$60 million	Lower Liability

\*The Rating Agencies suggest that the appropriate discount rate should be closer to 5%

\*\* Subsequent to the PwC report in September, the unfunded liability has increased from a projected \$682 million to an actual \$709 million. More evidence of an ever-deteriorating situation.

## Disagreement Only a Matter of Scale

- The Administration believes that the city has a \$709 million unfunded liability and needs to increase annual payments to at least \$90 million
- The union believes that the city has a \$301 million unfunded liability and needs to increase annual payment to \$60 million
- We have a substantial issue that must be addressed, period.

# Consequences of Inaction

- New accounting rules require that unfunded pension obligation be recognized as a current liability, just like any other debt – like bond debt
- Rating agencies will downgrade cities with large unfunded liabilities – and no plan to close the gap.
  - Downgrades will increase interest expense and take operating dollars away from vital city services
  - Vital infrastructure investments in everything from libraries and community centers to roads and buildings could be delayed or cancelled
- State Comptroller can - and will - fix our financial problems if we don't fix them ourselves
  - See State Comptroller's May 20, 2013 letter
  - Access to credit markets could be limited

# We Are Not Alone

- Other state and local governments have experienced similar trends in their retirement schemes, and have responded with structural changes to their retirement benefit programs
- From 2009-2012, more than 40 states have enacted major changes in their retirement plans to address long-term funding issues
  - Increased employee and employer contribution levels
  - Reduced level of benefits provided in the plan
  - Moved from traditional Defined Benefit plans to modified DB, DC, or combination of both
- Examples
  - Kentucky, Kansas and Louisiana moved to a Cash Balance DB Plan
  - Utah instituted employee choice for new employees of DC plan or a hybrid plan
  - State of Tennessee recently converted to hybrid plan design

# Goals and Alternatives

- GOALS
- We need a plan that will minimize
  - Volatility of contributions (ARC)
  - Balance sheet liability
  - End guarantees of a fixed investment return regardless of market fluctuations
  - End guarantee of a 62.5% of final average salary after only 25 years of service
- But will be sufficient for
  - Recruiting and retention objectives
  - Providing retirement benefits valued by employees
- ALTERNATIVES
- After consultation with our experts, *three basic alternative retirement benefit designs have emerged* for future employees and non-grandfathered participants:
  - Defined Contribution (DC) plan
  - Cash Balance (CB) plan
  - Hybrid Pension plan

# Summary of Alternatives

	Current	Proposed
	"Traditional" Defined Benefit ("DB") Pension Plan	Defined Contribution ("DC") Plan
Plan Description	<ul style="list-style-type: none"> <li>- Guarantees monthly payments from retirement until death of member and/or beneficiary;</li> <li>- Payments are a function of years of service and final salary.</li> <li>- Employee contributes 8% and City contributes 6% to fund the benefit.</li> <li>-- Assets/investments are managed by the plan and not by each employee.</li> </ul>	<ul style="list-style-type: none"> <li>- Employee has individual account.</li> <li>- Employee contributes 8%, City contributes 6%.</li> <li>- Account increases (decreases) with actual investment returns.</li> </ul>
		<ul style="list-style-type: none"> <li>- A DB plan.</li> <li>- Hypothetical account balance (looks similar to DC plan). Account can be paid as lump sum or annuity at retirement. Account increases with 14% of salary.</li> <li>- "contribution" or pay credits of 14% of salary (funded 8% Employee and 6% City) and interest credits of 7.5% on acc't.</li> <li>-- Assets/investments are managed by the employer and not participant directed.</li> </ul>
Who Has Investment risk	Employer	Employee
Volatility Impact on Balance Sheet	Volatile due to interest rate and investment risk	None
Mortality risk	Employer takes on longevity risk	Employee retains risk
Employee perception	<ul style="list-style-type: none"> <li>- Not always fully appreciated by all employees</li> </ul>	<ul style="list-style-type: none"> <li>- Account balance easy to understand</li> <li>- Portable</li> </ul>
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		<ul style="list-style-type: none"> <li>- Account balance easy to understand</li> <li>- Portable</li> </ul>
		<ul style="list-style-type: none"> <li>- Less than traditional pension; more than DC</li> <li>- Employee has risk if lump sum is elected; employer/insurer if annuity is elected</li> </ul>
		<ul style="list-style-type: none"> <li>- Employer and Employee Share</li> </ul>
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# Administration Recommendation:

## *Defined Contribution Plan*

- Defined Contribution Plan (New & Unvested Employees Only)
  - 8% contribution by City (up 2 percentage points)
  - 8% contribution by employees
- Employees keep the current 457 DC plan into which the employee could make additional, voluntary contributions, as they do today
- Employees with 10 years service (“Vested”) will stay with the defined benefit plan (the “Legacy Plan”)

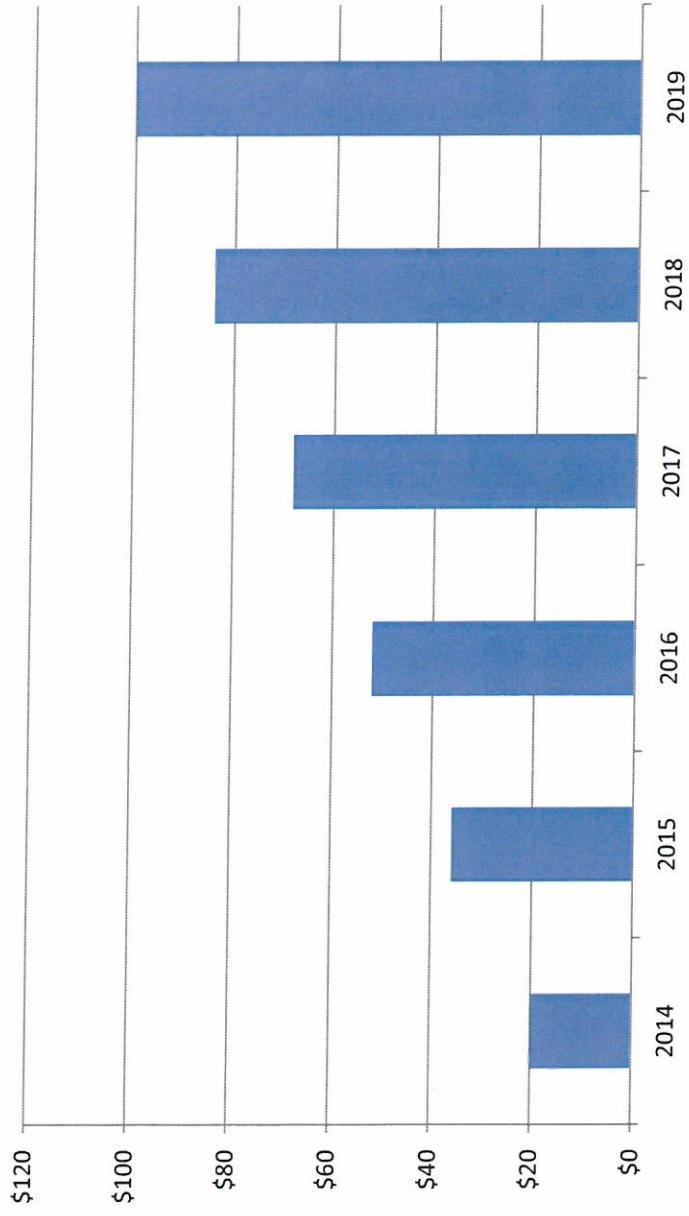
# Transition Plan

- Grandfather of Vested Employees only
  - Close DB plan to unvested and new employees as of 6/30/2014 – vested employees stay in DB plan
  - As of 7/1/2014, enroll all unvested and new employees into Defined Contribution Plan (DC Plan)
  - Unvested employees will be able to move their contributions from the Legacy Plan over to the new DC Plan/457 Plan

# Transition Plan

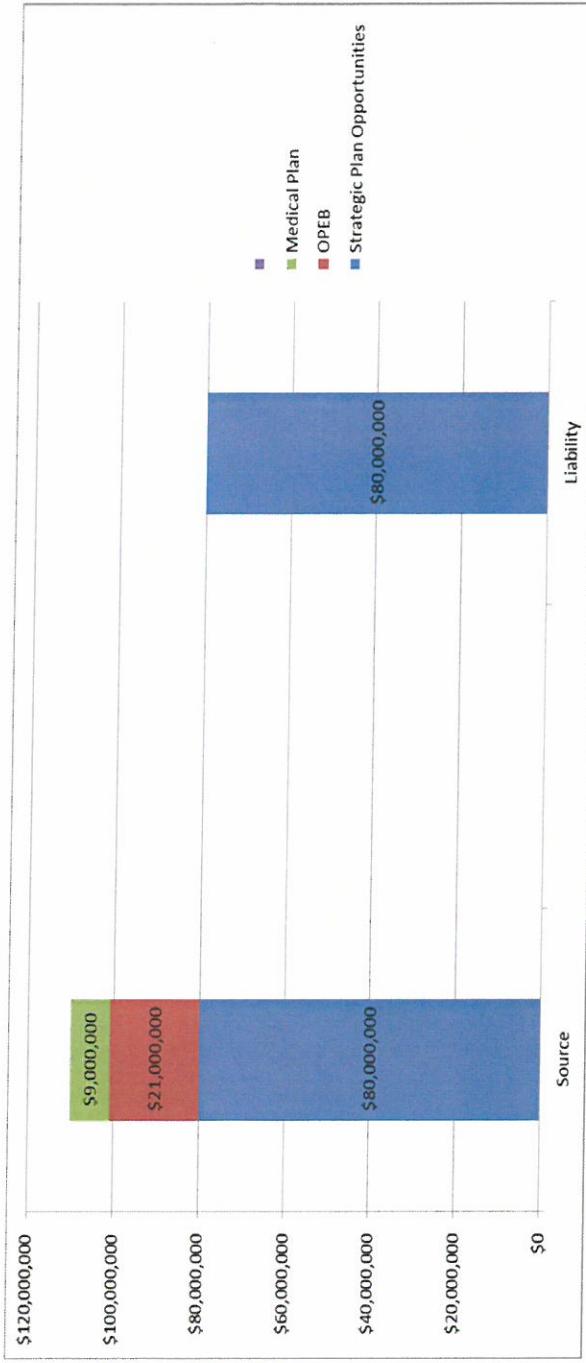
- Amortize unfunded liability over 30 years
- \$90 - \$100 million/year total cost: Annual amortization cost of legacy DB plan, plus normal cost of Legacy DB and new DC Plan
- Recommend a 5 year ramp-up period to that level of funding
  - Will require some research and negotiation with Nashville to ensure ramp-up is acceptable

# Five Year Plan to Fund Pension Gap



- Current pension contribution by City is 6% of salary expense, or approximately \$20 million annually
- Plan is to grow contribution aggressively over five years, or until ARC gap is filled

# Five Year Plan to Close Pension Gap



- To get back on track, we must increase Pension ARC by \$80 million annually
- Identified nearly twice that amount (\$140 million) in cost cuts and revenue enhancements
  - \$80 million in efficiencies identified in Five Year Strategic Plan
  - \$21 million of savings associated with redesign of our OPEB (Retiree Medical) plan
  - \$9 million of savings associated with redesign of our employee medical plan
- Plan is to phase in selected initiatives over five years to achieve a near straight line increase in Pension contribution from \$20 million to \$100 million annually

# Summary

- Implement Five Year Strategic Plan initiatives to drive majority of cost savings
- Modernize Pension and OPEB benefits to reflect trends in private and public sectors
  - Grandfather vested employees in DB Pension plan; DC Plan to unvested and new employees
- Shift these cost savings to unfunded pension liability over next five years and continue to pay ARC every year thereafter

# The Road Ahead

- Administration will
  - December 17, 2013 - Today
    - Recommend closure of existing defined benefit plan and adoption of a new DC pension plan
  - December, 2013 - January, 2014
    - Work with regulators to determine acceptable phase-in period for filling unfunded liability gap
  - February – March 2014
    - Develop and present framework to Council for long term implementation plan to fill unfunded liability gap
  - April 2014
    - Present 2015 Budget which will incorporate all efficiencies and other recommendations necessary for implementation